

# AN ANALYSIS OF ROTH CONVERSIONS

In 1997, Congress introduced the Roth IRA, giving investors a new product for retirement savings. The Roth IRA is essentially a mirror image of the Traditional IRA, but with a few important differences. Unlike with Traditional IRAs, Roth IRA contributions are not tax-deductible, so taxpayers investing in a Roth must recognize income in the contribution year. However, Roth IRAs offer a big advantage when compared with the Traditional IRA — whereas qualified withdrawals from Traditional IRAs are subject to ordinary income taxes, qualified withdrawals from a Roth are generally income tax-free.

In the 10-plus years since their inception, Roth IRAs have grown in popularity. In 2006, Congress introduced Roth 401(k) and 403(b) plans — which combine the features of Roth IRAs and 401(k)/403(b) accounts — helping to further extend the popularity of Roth plans. We anticipate that the popularity of Roth IRAs and Roth 401(k)/Roth 403(b) plans will continue. One reason for our conclusion is that while the tax code has historically prevented people with taxable income above certain amounts from converting their traditional plan into a Roth plan, beginning in 2010 Congress intends to lift these income limitations. Essentially, all taxpayers will be able to do a Roth conversion beginning in 2010.

This article is intended to help you better understand Roth conversions, so you can decide whether doing one will make sense for you in 2010 or later years.

## WHAT IS A ROTH CONVERSION?

A Roth conversion is done by converting or rolling over an existing traditional IRA and/or tax qualified plan (e.g., 403(b), 401(k) or 457) into a Roth plan.<sup>1</sup>

While the income tax-free withdrawals that Roth plans offer make them an attractive investment option, there are significant tax implications to doing a Roth conversion. If you're eligible, you need to decide whether it is advisable for you to convert.

## ELIGIBILITY REQUIREMENTS FOR CONVERSIONS

In order to do a Roth conversion, you must meet certain eligibility requirements:

- If you are married, your *filing status* must be “married filing jointly” in order to qualify for a conversion. If your filing status is married filing separately, you do not qualify for a conversion unless you have lived apart from your spouse for the entire tax year.



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- For 2009, your *modified adjusted gross income* cannot exceed \$100,000. Starting in 2010, this income limit will be removed, which means that essentially everyone will become eligible to do a conversion beginning in 2010.<sup>2</sup>
- If you inherit an IRA from someone other than your spouse, this IRA does not qualify for conversion; an inherited account from a spouse only qualifies for conversion if you first elect to treat it as your own IRA and then convert it. A non-spouse beneficiary can convert an inherited traditional retirement plan such as a 401(k) or 403(b) to an inherited Roth IRA, provided the beneficiary meets the definition of a designated beneficiary for minimum distribution purposes and is otherwise eligible to convert.

## **ADVANTAGES OF A ROTH CONVERSION**

The primary advantage of a Roth plan is that the asset growth, dividends and interest within it are not taxable while assets are held in the plan (as in traditional plans); however, when you withdraw assets from the Roth plan, the distributions are income tax-free under certain conditions (unlike traditional plans, in which distributions are generally taxable).

Roth conversions offer other potential advantages:

- Lifetime minimum distribution rules, which generally require you to begin taking distributions from traditional retirement plans starting at age 70½, do not apply to Roth plans. In fact, with Roth plans, there is no required beginning date at which you must begin distributions.<sup>3</sup> Therefore, while required distributions will eventually diminish the amount of funds in a traditional retirement plan or IRA, Roth plans have the potential to keep growing larger over your lifetime. Upon death, however, the minimum distribution rules do apply to the named beneficiary of a Roth plan, although qualified distributions to the beneficiary continue to be income tax-free.
- There is no maximum age for making contributions to a Roth IRA. In contrast, for Traditional IRAs, the maximum age for contributing is 70½. (When investing in either a Roth IRA or a Traditional IRA, the maximum regular contribution for the 2009 tax year is \$5,000 of earned income, or an additional \$1,000 if you are age 50 or older.)
- There is tax diversity among your retirement plans, which means that having both a traditional plan and a Roth plan allows you to control how much cash flow comes from pre-tax and after-tax sources during your retirement. This flexibility can help you if you are on the border between two tax brackets.
- Roth conversions are generally risk-free in the short term. This is because the IRS gives you until April 15 (or October 15 if you extended the due date of your income tax return) of the year after you convert to switch back to a traditional plan.

## ISSUES TO CONSIDER BEFORE CONVERTING

The income tax-free withdrawals that Roth plans offer make them an attractive investment option. But because of the tax issues associated with Roth conversions, finding out whether a conversion makes sense for you — and determining how much to convert and when — requires carefully analyzing your tax situation.

**Roth Conversions Are Taxable:** A Roth conversion is a taxable event, which means that the converted amount is includible in your gross income in the year you convert (except to the extent it represents a return of any non-deductible contributions).<sup>4</sup> However, for conversions made in 2010 only, a special rule allows you to spread any income recognition on the converted amount in equal proportions over a two-year period, beginning with calendar year 2011.<sup>5</sup>

There is no limit on the amount you can convert to a Roth plan. There is also generally no limit on the number of times you can convert in any given year, or the number of times you can convert assets from a single plan in the same year. Partial conversions to a Roth plan are also permitted. For example, if you have multiple Traditional IRAs, you can choose to convert one or more of them. Or, if you have a single Traditional IRA, you can choose to convert only a portion of it. Doing a partial conversion may make sense if you are concerned that converting the entire plan will push you into a higher tax bracket. Please note, however, that same-year reconversions are not allowed, which means that you cannot switch back from a Roth IRA to a traditional IRA and back again to a Roth IRA in the same taxable year.<sup>6</sup>

**Payment of Tax on Conversion:** The IRS treats a conversion from a traditional plan to a Roth plan as a distribution, and thus the conversion amount is included in your gross income to the extent an actual distribution of the same amount from your traditional plan would have been taxable. You will pay tax on the converted amount at your applicable tax rate.

If you are younger than age 59½, you will likely incur a 10% penalty on any portion of the converted plan that you use to pay the income tax liability and/or on any portion of the plan withdrawn for other reasons after the conversion. Therefore, if you are younger than 59½, it is generally suggested that you do a conversion only if you have adequate non-qualified (i.e., after-tax) assets available to pay the income tax liability. There are exceptions to this penalty tax if you are disabled or are buying a first home.<sup>7</sup>

If you are older than 59½, you can pay the tax from the converted assets without penalty. In such cases, carefully review your strategy because the tax payment from the Roth reduces the plan's size, resulting in fewer assets being available to grow tax-deferred in the Roth plan. Furthermore, you must be willing to abide by the five-year period (see the "Rules Governing Distributions" section on page 5).

Additionally, if you plan to pay the tax from non-qualified (i.e., after-tax) assets rather than from the converted assets, consider whether you will incur significant capital gains when raising the cash. Taxation of the converted amount, combined with the capital gains taxation, could result in your having to pay more tax now than your beneficiary would have to pay upon your death if you had left the assets in the traditional plan; this is because non-qualified assets generally receive a step-up in cost basis upon your death, thereby eliminating any capital gains tax.<sup>8</sup>

**Income Tax Rates:** If you expect to be in a lower income tax bracket in the future, then it might be more beneficial for you to keep your assets in the traditional plan for now. But if you expect to be in a higher income tax bracket in the future, there may be a greater benefit to doing a conversion.<sup>9</sup>

You should also consider the projected income tax brackets for your named beneficiary. If you expect your beneficiary to be in a lower income tax bracket than you, then you may see more benefit to keeping your assets in the traditional plan and allowing the beneficiary to recognize the tax upon your death. In this situation, your beneficiary generally has substantial flexibility to “stretch out” distributions from the traditional plan.<sup>10</sup> Another planning strategy is to think about making any charitable contributions during the conversion year to lessen potential income tax implications. If your earned income exceeds \$250,000, be aware that Congress is considering limiting your itemized deductions to 28%. In this situation, a donor-advised fund might be a good solution since it allows you to accelerate the deduction and gives you flexibility to award charitable grants over time.

**Investment Performance:** Pay attention to the financial markets. You do not want to pay federal and state tax now on a traditional plan only to see the account’s value decrease later.

**Beneficiary Considerations:** If your individual beneficiary (or a trust you established for the beneficiary’s benefit) is in a higher income tax bracket than you, a conversion might make sense. This is especially true if you do not need to draw upon the plan during your life and can pay the income tax liability from other assets. Also, if you wish to leave a plan to a non-citizen spouse or to a trust for a special needs child, a conversion might be a good strategy because it removes income tax considerations from the equation.

Please note that an inherited Roth plan is not generally protected from a beneficiary’s creditors. So if your beneficiary has professional liability concerns, a bad marriage, a disability, or credit issues, then consider establishing a qualified trust for this person’s benefit, which includes spendthrift trust provisions, for asset protection purposes.

**Rules Governing Distributions:** In the event you need access to your funds in the short term, be aware of the rules governing Roth distributions. Specifically, in order to make a qualified distribution, you need to satisfy two tests:

- You must be at least 59½ years of age or qualify for one of the exceptions to receive a qualified distribution.<sup>11</sup>
- You cannot take a distribution from a Roth IRA account for at least five years after the conversion. Under this five-year period rule, you must generally wait at least five years from the first day of the tax year in which you made the conversion before you can take a qualified distribution.

If you have multiple Roth IRA accounts, each account is governed by the same five-year period. However, if you have multiple employer plans — e.g., a Roth 401(k) and a Roth 403(b) — each plan is governed by a separate five-year rule. The only exception is if you make a direct transfer from one employer plan to another, in which case the starting date for whichever account is older applies; this exception only applies to direct transfers and not to rollovers.

**Conclusion:** It is critical that you work with a qualified attorney or tax advisor and that you continue to obtain input from your Trust Administrator, Wealth Management Advisor, and other Advisors, when needed, to develop a fundamental understanding of the Roth conversion strategy and be able to know how to apply this strategy to your specific circumstances.

<sup>1</sup> Distributions from tax-qualified retirement plans — including 401(k) plans, tax-sheltered annuities (section 403(b) plans), and governmental 457 plans — are candidates for conversion effective as of 01/01/08. You can also convert a Simple IRA, but only after you participate in the Simple IRA plan for at least two years.

<sup>2</sup> See the Tax Increase Prevention and Reconciliation Act. To calculate your modified adjusted gross income, begin with your adjusted gross income (AGI) and subtract any income resulting from the Roth conversion. Then, subtract any amount included in your AGI by reason of a required minimum distribution from an IRA or tax-qualified plan. Next, add your full Social Security benefits for both you and (if you're married) your spouse. You then add any miscellaneous deductions and exclusions if they were claimed by you in your AGI (e.g., deduction for traditional IRA contributions, student loan interest expenses, tuition expenses, foreign earned income and housing costs, income resulting from redemption of U.S. Savings Bonds (Series EE) used to pay higher education expenses, deduction for passive activity losses, and qualified adoption expenses paid by your employer).

<sup>3</sup> Distributions from a Roth IRA cannot be used to fulfill a minimum distribution requirement arising from a traditional retirement plan account.

<sup>4</sup> For tax purposes, the IRS treats all IRAs as a single IRA, even when the IRA consists of deductible and non-deductible contributions. Therefore, there is no advantage to taking a distribution from the IRA with the greatest non-deductible contributions. Please note that you cannot convert only the non-taxable portion of a plan.

<sup>5</sup> See the Tax Increase Prevention and Reconciliation Act.

<sup>6</sup> If you do a Roth conversion and decide you are unhappy about it, or if you discover that you were not eligible to convert, you can “recharacterize” the conversion, i.e. switch back to your traditional plan. For example, if you converted to a Roth IRA in 2008 and discovered that your 2008 modified adjusted gross income exceeded the \$100,000 limit, you have until April 15, 2009 (or October 15, 2009 if you extended the due date of your income tax return) to switch back to a Traditional IRA. This transfer back must be made on a “trustee-to-trustee” basis instead of by rollover, the original contribution and net income must be transferred back, and irrevocable notice must be given to the plan trustee. You generally cannot do a reconversion until the later of: 1) the taxable year following the taxable year of the original conversion, or 2) 30 days after the switch back.

<sup>7</sup> Since you already paid the appropriate tax on the original conversion amount for the calendar year in which you converted the asset, the tax and penalty amount is generally imposed upon the earnings rather than upon the original conversion amount.

<sup>8</sup> Some analysts anticipate that Congress will raise the capital gains tax rates that are applicable to high-income earners, which would generally increase the tax cost of Roth conversions.

<sup>9</sup> Some analysts anticipate that Congress will also soon raise the income tax rates applicable to high-income earners.

<sup>10</sup> Most 403(b)s, 457(b)s and IRAs permit beneficiaries to use their own ages to determine the applicable divisor. Sometimes called “stretch-out” planning, this strategy gives the beneficiaries of inherited plans the flexibility to achieve maximum compound tax deferral inside the plan. When considering stretch-out planning, it's important to tailor the beneficiary designation forms carefully. Since IRS regulations can be complex, consider using the services of an attorney or tax advisor. Also, check with your plan administrator to make sure that stretch-out planning is available under your plan.

<sup>11</sup> There is an exception for a disability, your death, or if you qualify as a first-time home buyer.

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